

INDEPENDENT EVALUATION GROUP (IEG)

EVALUATION OF WORLD BANK GROUP GUARANTEE INSTRUMENTS

APPROACH PAPER

Background

1. The World Bank Group (WBG) uses a variety of guarantee instruments to support its development objectives. By mitigating risks, WBG guarantee instruments have the potential to mobilize private sector financing for development purposes, accelerate the flow of foreign direct investment, promote infrastructure development, open new markets, and encourage private sector participation in public-private partnerships.

2. Since the late 1980s, the WBG has been expanding the menu of its guarantee instruments and currently offers a range of products to both member governments and the private sector through the three WBG institutions (see Annex for a more detailed description of the various WBG guarantee instruments):

- **MIGA** was established in 1988 as a specialized agency to provide **political risk insurance** that covers foreign private investors against four types of non-commercial risk—currency transfer restrictions, expropriation, war and civil disturbance and breach of contract. Since its inception, MIGA has provided US\$16.7 billion worth of guarantees (884 guarantees for 556 projects) in 95 countries. Guarantees comprise the core of MIGA's business. In connection with its guarantees MIGA offers mediation and dispute resolution services to clients and host governments.
- **IFC** initiated its guarantee commitments in the early 1980s, but its guarantee portfolio remained very small until the late 1990s. Today IFC guarantee products comprise **direct debt substitutes, commercial operation, and the Global Trade Finance Program (GTFP)**¹. IFC has approved a total of US\$3.7 billion in guarantees over FY99-FY07 in 168 projects in 62 countries. Guarantees represent about 6 percent of IFC's committed portfolio.
- **IBRD/IDA**, began mainstreaming its guarantee operations in 1994. It offers two distinct guarantee products: **(a) partial credit guarantees** that cover commercial lenders against all risks during a specified period associated with public sector borrowing from commercial markets; and **(b) partial risk guarantees** that cover commercial lenders against default on a loan, normally for private sector projects, when such default is the result of a government's failure to meet its obligations. Between FY94-FY07, IBRD/IDA approved 10 partial credit guarantees and 21 partial risk guarantees for a total approved amount of US\$3.6 billion in guarantees (31 guarantees in 26 countries). Guarantees comprise about 1 percent of IBRD/IDA business.

¹ Investment Products Schema, <http://ifcnet.ifc.org/intranet/op.nsf/content/home>

3. In the recent past, two main issues have been raised by Board members, private sector clients, and other stakeholders concerning WBG guarantees. These are:

(i) **Instrument use.** Despite the dramatic growth in private finance to developing countries, the consensus in the development community is that there is significant untapped potential for greater involvement of the private sector in meeting needs for development-oriented investments². Guarantees and other risk mitigating products are viewed as particularly well suited to unlock this potential. In this context, concerns have been raised that guarantees are an underused instrument within the WBG. While the FY94 Memorandum to the Board that established the guidelines for IBRD/IDA guarantees expected a volume of US\$1-2 billion a year, actual guarantees approvals have amounted to US\$3.6 billion over 13 years.³ The amount of MIGA's guarantee exposure has remained fairly constant since FY01. IFC's recently introduced GTFP is growing rapidly, however the use of its traditional guarantee instruments (DDS) has been on a declining trend in recent years. At present, WBG guarantees comprise only a small portion of the total guarantees market: the total volume of WBG guarantees over the past 18 years has been US\$24 billion, compared to US\$36 billion in investment guarantees underwritten by members of the Berne Union (an organization of 70 leading export credit and investment insurance agencies) in 2005 alone.⁴ Other views point to a significant untapped potential for the WBG in mobilizing private capital through risk mitigation activity.⁵

(ii) **Organization of the provision of guarantees within the WBG.** Concerns have also been raised that the organization of the provision of guarantees within the WBG is not optimal and that overlap exists between the three institutions that may confuse clients and reduce efficiency. There have been several initiatives to address this issue. In FY97, the Board reviewed the WBG's guarantee activities and looked at proposals to improve the Group's operational synergy in the provision of risk mitigating products.⁶ In FY05, there was an attempt to develop a more coordinated approach between the Bank's Partial Risk Guarantee Group and MIGA in order to increase the use of existing guarantee instruments, especially in the infrastructure sector. More recently, a task force has been established to explore options for optimizing the delivery of guarantees within the Group.

Scope of the Evaluation

4. Although guarantees instruments have been an established product line of the WBG over the last two decades, they have not been subject to a rigorous evaluation in one study covering all

² The UN Millennium Project has estimated the MDG's financing gap to be \$73 billion a year in 2006 for low-income countries and \$10 billion a year for middle income countries.

³ "Mainstreaming of Guarantees as an Operation Tool of the World Bank", Memorandum to the Executive Directors, July 11, 1994.

⁴ 2007 Yearbook. Berne Union.

⁵ See World Economic Forum, *Building on the Monterrey Consensus: The Untapped Potential of Development Finance Institutions to Catalyze Private Investment*, 2006

⁶ Overview of the World Bank Group's Guarantee Activities, March 19, 1997, SecM97-209.

three institutions. IEG plans an evaluation of the World Bank Group's experience with its range of guarantee products. The evaluation approach involves mapping the WBG guarantee instruments, assessing their relevance for the WBG's strategic objectives and priorities, and the efficiency of their provision by the WBG. In doing so, it will seek to assess the extent to which the development potential for enhanced use of WBG guarantees, as identified by previous programs and strategies, has been realized in practice and the role of both external and internal factors in constraining or enhancing the process. The study will aim to inform the on-going discussion of the WBG's Long Term Strategic Exercise, which envisions an expanded role for guarantee instruments. It will seek to address the following questions:

A. Mapping of WBG Guarantee Instruments

What is the nature of the guarantee instruments offered by the WBG and how they operate?

5. **Mapping the WBG guarantee product range.** The study will classify the products of the three institutions according to types of risk covered, clients, beneficiaries, and other relevant characteristics. It will then place the WBG's guarantee activities into the context of the broader market for guarantee instruments in which the various public and private sector investment insurance agencies currently operate.

6. **Relationship between guarantees and other WBG instruments:** To what extent do WBG guarantees complement or compete with other WBG instruments? The evaluation will identify and illustrate the relationships of substitutability or complementarity - both on the supply and demand side - between guarantees and other WBG instruments. Comparisons with other WBG products will focus on political risk mitigating instruments such as IFC's Guarantee Offshore Liquidity Facility (GOLF) and Credit Enhanced Lending Transaction (CELT).

7. **Methodological aspects:** In defining the scope of the evaluation, the study will rely on product definitions used by the three WBG institutions. Comparisons with other WBG products will be limited to close substitutes. The main sources of information will be internal project and policy documents, literature reviews, and inputs from external experts.

B. Relevance of the WBG's Guarantee Instruments

Should the WBG be in the guarantee business?

8. The relevance of the WBG guarantee instruments will be assessed according to the following criteria.

- a. **Strategic importance and relevance:** Are guarantee instruments consistent with the current strategic objectives and priorities of the WBG? The evaluation will identify the assumptions behind the mandates for guarantee instruments in the three WBG institutions and assess the extent to which they continue to be valid given the current external environment and strategic priorities of the WBG.
- b. **Conditions for Using WBG Guarantees:** Under what conditions are WBG guarantee products appropriate for use, and when might they not be? The evaluation

will examine how WBG guarantee products might complement and enhance private sector offerings, and when they might merely substitute for what is already available in private or public sector offerings.

- c. **Market comparisons:** To what extent do WBG guarantee instruments address areas not covered by other providers of risk mitigation instruments? Subject to data availability, the evaluation will look at trends in the broader market for risk mitigating products for private investment in developing countries.

9. **Methodological aspects:** For market comparisons, this part of the study will rely on the use of external data sources, market reports, Berne Union, and inputs from external experts/advisors. In doing so, the study is likely to encounter data limitations as many of the relevant transactions are private and therefore not widely reported. Furthermore, the availability of external data may not match the product classification of the WBG and therefore strict comparisons may not be possible. For the analysis of strategic importance and WBG the study will make use of internal project and program documents, internal reports and reviews, and interview with staff and external practitioners.

C. Effectiveness of the WBG's Guarantee Instruments

To what extent have guarantees advanced the Bank Group's development objectives?

10. The evaluation will evaluate the contribution of WBG guarantee instruments to the Group's strategic objectives.

- a. **Additionality of guarantees to investment projects:** To what extent have additionality aspects of guarantees, such as catalyzing investments and improving the terms of financing, motivated the use of the instrument by the WBG?
- b. **Extent of use in areas of WBG strategic priorities.** To what extent have guarantee instruments been used to advance WBG development objectives related to, for instance, fragile states, low income countries, global public goods, capital market and infrastructure development? What have been the major impediments to greater development effectiveness and higher level of demand for their use?

11. **Methodological aspects:** The evaluation will focus on 'guarantee-specific' additionality rather than the development impact of projects with WBG guarantees. The main sources of information will be project documentation, self-evaluations, existing independent evaluations combined with market and interview data.

D. Efficiency of the Provision of WBG Guarantee Instruments

Is the delivery of guarantee products in the WBG appropriately configured to maximize effectiveness?

12. **Delivery mechanisms:** How is the WBG organized to deliver guarantee products to its clients? The study will compare the marketing, pricing, processing and supervision structures and

procedures for guarantee instruments within each of the three WBG institutions. A comparison will then be made between the WBG structures and procedures with selected other multilateral and private providers of comparable guarantee instruments.

13. **Division of labor and cooperation:** The study will analyze (i) whether the mandates of the WBG units offering guarantee products are clearly defined both in theory and in practice; (ii) the extent to which the division of labor between the three WBG institutions corresponds to the complementarity and substitutability that exist between the various guarantee instruments; and (iii) the experience with collaboration within the Group in delivering guarantee products.

14. **Cost of delivery:** What does it take to deliver WBG guarantees products both in terms of processing time and administrative costs? What factors have the biggest impact on costs? Indicators of transaction processing costs will be compared with substitute products, if applicable. The study will also review the investment performance of guarantees by the WBG, including claims analysis.

15. **Methodological aspects:** Main sources of data will be internal management information systems, operational policies and procedures, case studies, and interviews. Comparisons between the guarantee instruments of three institutions of the WBG will focus on close substitutes.

Methodology

17. The evaluation will rely on: (a) literature review to provide a conceptual framework; (b) independent evaluation results of WBG guarantee projects; (c) quantitative data from external and internal WBG sources; (d) qualitative first hand information drawn from interviews/survey with Bank Group staff, clients, other guarantee providers (both public and private sector); and (e) case studies to complement quantitative and qualitative information. The case studies would be of projects, products, or programs and the selection would be based on the extent to which they illustrate some of the main themes and findings, for example instances of collaboration between the three institutions in joint projects or innovation through new products or programs. The evaluation will also rely on experts in the field of guarantees and financial sector development who will be expected to prepare background papers on product mapping, market trends and relevant private sector and MFIs experiences.

Team, Timeline and Cost

18. This study is a joint IEG-IFC, IEG-MIGA and IEG-WB evaluation and will be conducted by staff from all three units assisted by expert consultants. The study will be managed by Asita De Silva (IEG-WB), Ethel Tarazona (IEG-MIGA), and Stoyan Tenev (IEG-IFC). Stoyan Tenev will be the overall coordinator of the team. Peer reviewers will be appointed from within and outside the WBG. The evaluation is expected to be delivered to CODE in April 2008.

IFC Guarantee Operations

Direct Debt Substitutes

Definition: A credit enhancement mechanism for debt instruments (bonds and loans). It is an irrevocable promise by IFC to pay principal and/or interest up to a pre-determined amount, irrespective of the cause of the payment default. It can be applied to a single credit or to a portfolio of credits.

Example (single credit): The Municipality of Guatemala is planning a US\$45 million investment in an urban transport project. The project will be financed by a syndicated 10-year loan totaling US\$45 million. Banco de Occidental (BdC) has structured this loan, which is backed by municipal revenues. IFC provides a guarantee on a percentage of Banco de Occidente's total exposure to the municipality.

Example (portfolio of credits): IFC provided a partial guarantee to The Trust Bank of Ghana on loans extended to finance investments in education. The facility is structured as a risk-sharing guarantee with The Trust Bank. IFC's guarantee covers 50% of the principal credit losses that are in excess of a 5% first loss threshold. The guarantee is for an amount up to a maximum of 9.5 billion Ghanaian Cedis (US\$1.07 million equivalent). The portfolio will be originated according to underwriting criteria defined jointly by The Trust Bank and IFC. All existing loans originated by The Trust Bank that meet the criteria are automatically put into the Facility.

Commercial Operation

Definition: Credit enhancement guarantee in a non-lending situation where the objective is to back up a client's performance of its obligation in a commercial transaction involving the provision of goods and services.

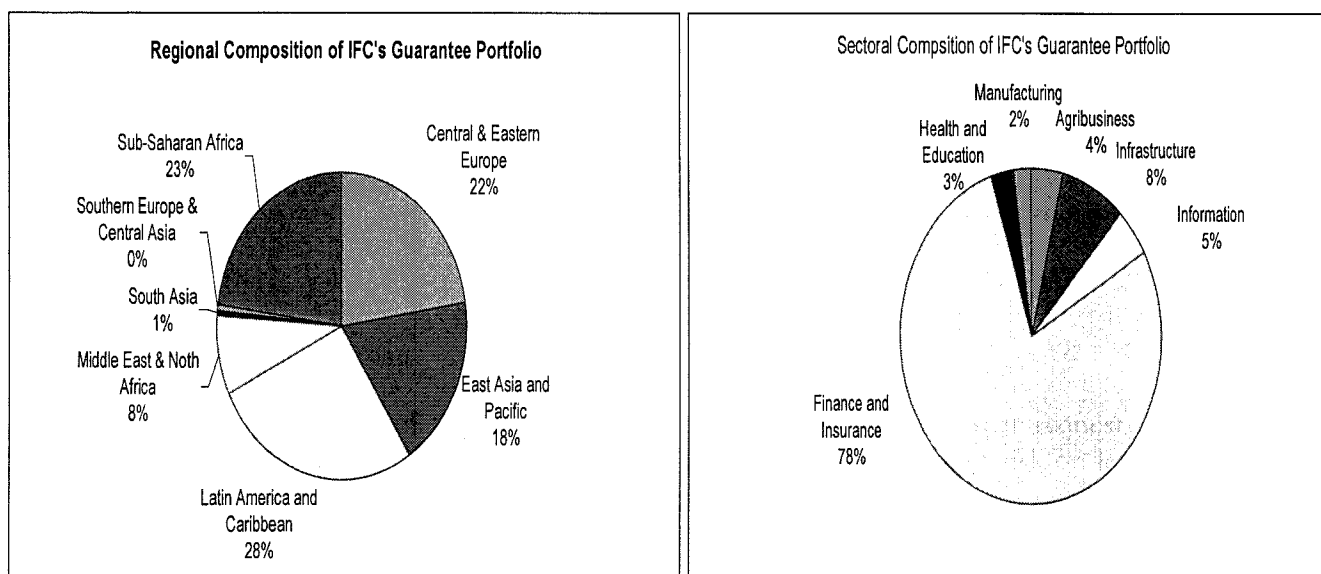
Example-Carbon Delivery Guarantee (CDG): Dongyue Chemical's production lines create a byproduct, HFC-23, which is a potent greenhouse gas (GHG). The company will install new equipment to collect this by-product and decompose it into a harmless gas. This decomposition project can claim Carbon Emission Rights (CERs) and sell them to companies or governments in countries that have committed to GHG reduction under the Kyoto Protocol. IFC proposes to purchase 15%, of 50 million CERs that Dongyue Chemical will generate during the 2008 - 2012 period. IFC would guarantee delivery to third party buyers of up to the first 4.5 million CERs delivered to IFC (or only 60% of the total purchase). IFC would sell the remaining 40% of the total purchase (or approximately 3.0 million CERs delivered subsequently) on a non-guaranteed delivery basis, thereby giving IFC a 40% buffer against under-delivery by Dongyue Chemical in case for any reason the company does not generate and deliver the CERs as expected.

The Global Trade Finance Program (GTFP)

Description: In a typical letter of credit trade transaction, the buyer applies to the issuing bank for the issuance of a letter of credit (LOC) in favor of the seller (beneficiary). The confirming bank, at the request of the issuing bank, assures that drawings under the credit will be honored

provided the terms and conditions of the credit have been met. The Global Trade Finance Program offers confirming banks partial or full guarantees covering payment risk on issuing banks in the emerging markets.

How it works: The program works through major commercial banks that request, on a per-transaction basis, partial or full guarantees from IFC to cover the payment risk on local financial institutions. In most instances, the guarantee is requested subsequent to a commercial letter of credit that the bank is asked to confirm. On a selective and more limited basis, the program also provides cash advances to support pre-export financing and guarantees issued outside of documentary credits. Guarantees issued under the GTFP cover import and export transactions and extend to both political and commercial payment risks.



IFC's Guarantee Commitments (US\$ million)

Year	COP	DDS	GTFP	Total
1999	0	394	0	394
2000	0	4	0	4
2001	0	547	0	547
2002	0	270	0	270
2003	0	442	0	442
2004	0	271	0	271
2005	0	216	0	216
2006	154	165	269	588
2007	26	184	772	982

Note: COP-commercial operation
 DDS-direct debt substitute
 GTFP-global trade finance program

IDA/IBRD Guarantees

A. Partial Credit Guarantees

Description: Partial Credit Guarantees (PCGs) support public sector borrowing from commercial creditors to finance public investment projects. They cover commercial lenders against all risks during a specific period of the financing term of a loan for a public investment. Policy Based Guarantees (PBGs) are a type of PCG that cover a portion of debt service on government borrowing (through loans or bonds) from commercial creditors but are not associated with specific public investment projects. Instead, they support an agreed policy and institution reform program. At present, both PCGs and PBGs are available only in IBRD countries.

Example of a PCG: The Yangzhou Thermal Power Project in China involved the construction of a large coal-fired thermal power plant and related transmission lines in the Jiangsu Province for a total project cost of US\$ 1.1 billion. The project was partially financed through a US\$120 million loan from commercial lenders. IBRD issued a US\$120 million partial credit guarantee to support this loan in order to improve the maturity length and cost of the loan by mitigating the risk of default. The PCG guaranteed repayment of the principal outstanding to the commercial lenders from year 10.5 onward. The commercial lenders took the risk on principal and interest payments due prior to year 10.5.

Example of a policy-based PCG: In 2001, the government on Colombia completed a notes issuance to raise US\$1 billion from commercial markets to fill a funding gap in its public expenditure program. The issue was backed by an IBRD policy based guarantee of US\$158 million that guaranteed the semi-annual payments of interest and principal due to the lenders. Its objective was to help enable Columbia access US capital markets and improve the terms of borrowing from the market. The issue of the guarantee was made conditional on the implementation of a financial sector reform program agreed with the Bank.

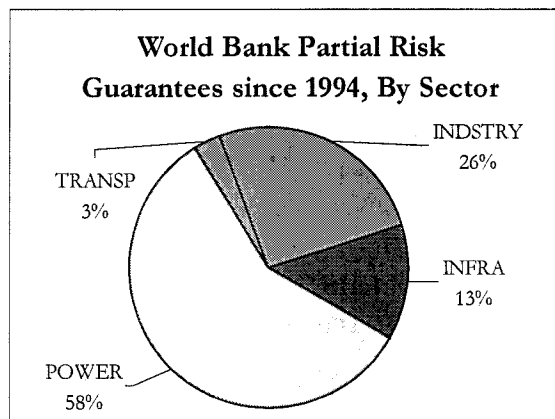
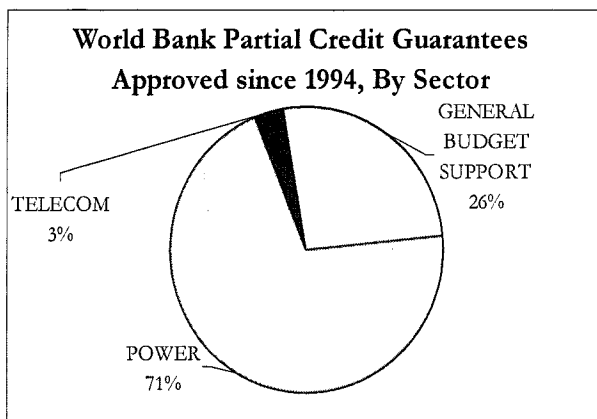
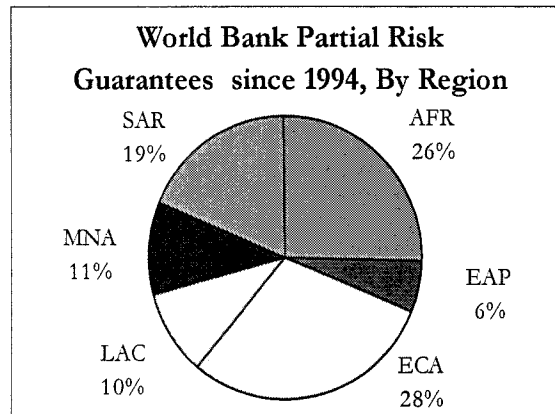
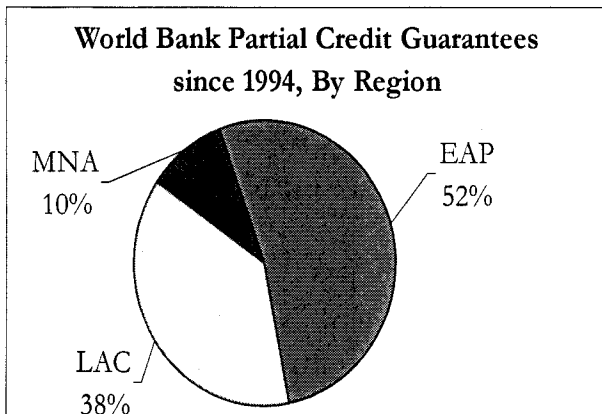
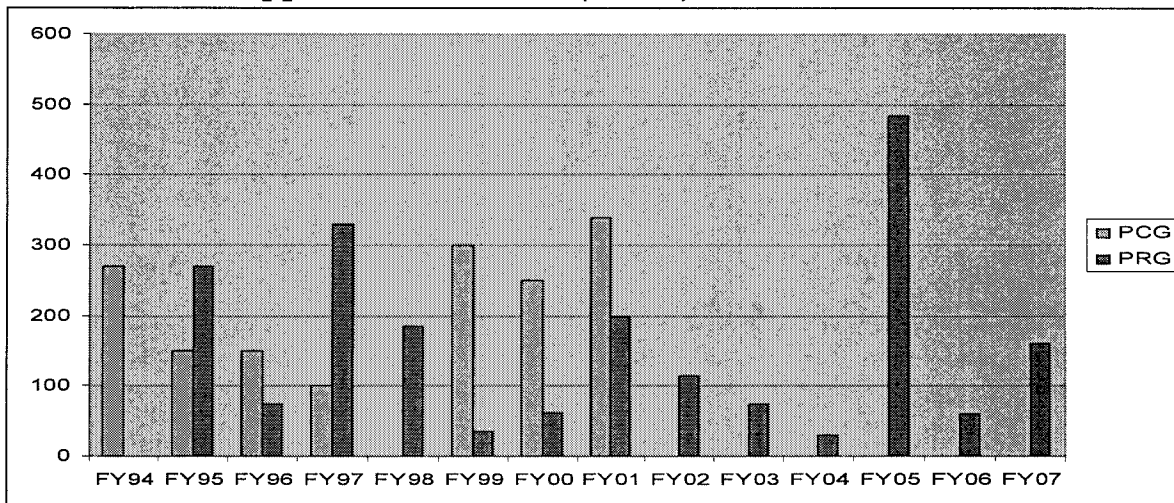
B. Partial Risk Guarantees

Description: Partial Risk Guarantees (PRGs) cover commercial lenders to a private sector investment project against default on a loan arising from a government-owned entity failing to perform its obligations with respect to the private investment project. PRGs can cover a range of risks relating to government performance including: (i) changes in law; (ii) failure to meet contractual payment obligations; (iii) obstruction of an arbitration process; (iv) expropriation and nationalization; (v) foreign currency availability and convertibility; (vi) nonpayment of a termination amount or an arbitration award following a covered default; or (vii) failure to issue licenses, approvals, and consents in a timely manner. PRGs can be provided in both IBRD and IDA countries. The Bank also offers IBRD enclave guarantees which are partial risk guarantees structured for export oriented foreign exchange generating commercial projects in IDA-only countries. The Bank has also supported establishment of several Guarantee Facilities in member countries that involve wholesaling partial risk guarantees in order to reach smaller projects.

Example of a PRG: In 1999, IDA provided its first PRG for the Azito Power Project in Cote d'Ivoire. The Azito Power project was a public-private-partnership under which a private company, CINERGY S.A., was awarded a contract to build, own, and operate a gas-fired power

generation plant and related transmission lines. The total project cost of US\$223 million was partially financed by a US\$30 million loan from commercial lenders to CINERGY. The IDA PRG provided coverage against debt service default on this loan by CINERGY resulting from the Government's failure to meet its obligations under the contractual framework of the award. The objective was both to mobilize commercial finance of the project as well as to enhance the terms the loan.

WB Guarantee Approvals since 1994 (US\$m)



MIGA Operations

Types of Guarantee Coverage Offered

Transfer restriction coverage protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties, or other monetary benefits) into foreign exchange for transfer outside the host country. The coverage also insures against excessive delays in acquiring foreign exchange caused by the host government's actions or failure to act. Currency devaluation is not covered.

Expropriation coverage offers protection against loss of the insured investment as a result of acts by the host government that may reduce or eliminate ownership of, control over, or rights to the insured investment. This policy also covers partial losses, as well as "creeping expropriation," a series of acts that over time have an expropriatory effect. Bona fide, non-discriminatory measures taken by the host government in the exercise of its legitimate regulatory authority are not considered expropriatory.

War and civil disturbance coverage protects against loss due to the destruction, disappearance, or physical damage to tangible assets caused by politically motivated acts of war or civil disturbance, including revolution, insurrection, and coups d'état.

Terrorism and sabotage are also covered. War and civil disturbance coverage also extends to events that result in the total inability of the project enterprise to conduct operations essential to its overall financial viability.

Breach of contract coverage protects against losses arising from the host government's breach or repudiation of a contractual agreement with the investor. In the event of such an alleged breach or repudiation, the investor would first need to invoke the dispute resolution mechanism (e.g., arbitration) set out in the underlying contract and obtain an award for damages. The investor may file for a claim if, after a specified period of time, payment is not received.

Examples of Guarantee Projects

Project Name: Termoguayas Generation S.A. (TGSA), Ecuador

Keppel Energy, through its subsidiary TGSA, has installed and is operating a 150 MW barge power project in Guayaquil, Ecuador. MIGA has provided \$102.6 million in investment insurance to Rodeo Power Pte. Ltd. (Rodeo) of Singapore and New Energy Industrial Ltd. (New Energy) of the British Virgin Islands, wholly owned subsidiaries of Keppel Energy Pte. Ltd. Rodeo and New Energy have respectively provided a shareholder loan for five years and equipment leases of seven years to TGSA. TGSA, the project enterprise, has entered into a 15-year concession contract with the National Electricity Council of Ecuador. MIGA's insurance is providing coverage against the risks of transfer restriction, expropriation, and breach of contract over the period of the loan and leases.

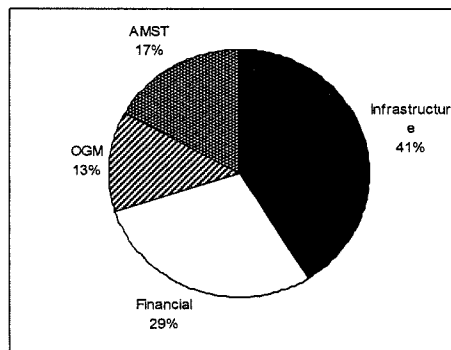
Project Name: Deqing Darco Producing Water Company, China

MIGA has issued a guarantee of \$7.56 million to Darco Environmental Pte. Ltd. of Singapore for its equity investment in the Deqing Darco Producing Water Company. The coverage is for a period of up to 20 years, against the risk of expropriation. The project consists of the

construction of a water treatment plant, on a build-operate-transfer basis, that will supply 100,000 cubic meters per day of potable water to residents and industries in Deqing County.

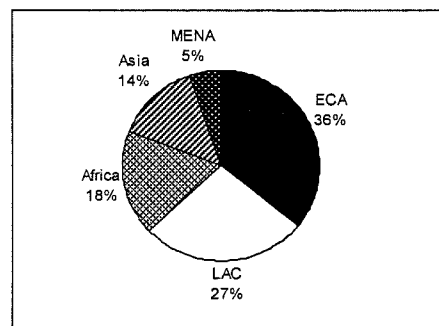
Outstanding Portfolio Distribution by Sector, Percent of Gross Exposure

	As of June 30 2007
Infrastructure	41%
Financial	29%
Agribusiness, manufacturing, tourism and services	17%
Oil, Gas and Mining	13%



Outstanding Portfolio Distribution by Host Region, Percent of Gross Exposure

	As of June 30 2007
Europe and Central Asia	37%
Latin America and the Caribbean	28%
Sub-Saharan Africa	18%
Asia	14%
Middle East and North Africa	5%



Portfolio Evolution

Guarantees Issued (By Fiscal Year)

